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SUBJECT: UKRAINE: POLITICAL CLASH HIGHLIGHTS CORRUPTION IN GOVERNMENT PROCUREMENT

Classified By: ECONOMIC COUNSELOR DOUGLAS KRAMER, REASONS 1.4 B) AND D)

¶1. (SBU) Summary: The GOU attempted to push through a controversial amendment to the government procurement law, causing indignation among political opponents and spurring claims that the Party of Regions was trying to grab public funds for their election coffers. Opposition by President Viktor Yushchenko, along with a court ruling against the GOU, appears to have blocked the amendment from taking effect. The story illustrates the sad state of Ukraine's procurement law and the corruption endemic to the system. Amendments to the procurement law in 2006-2007 actually made matters worse, introducing murky supervision, nontransparent special requirements, and sectoral exemptions. Foreign companies have little opportunity to compete for GOU tenders on an equal footing. Ukraine has committed to cleaning up its government procurement system in line with WTO rules, but thus far President Yushchenko appears to be the only major actor pushing for reform. End Summary.

Contentious Procurement Law

¶2. (U) On June 19, the Rada (parliament) approved a controversial bill that excluded all state-owned enterprises from requirements to follow government procurement rules, such as the announcements of open tenders. The law also stipulated an increase in the threshold requiring government procurement to be performed via open tenders (from US\$10,000 to \$20,000 for goods and services, from \$80,000 to \$120,000 for works). Because the law was passed after President Viktor Yushchenko's decrees dissolving the Rada, the President refused to recognize the legitimacy of the law and never signed it into force. First Deputy Prime Minister Mykola Azarov announced on July 5 that the GOU intended to implement the law regardless. (Note: If the Cabinet were to implement this law, it will be the first passed by the rump Rada that the Cabinet had chosen to move forward on. End note.) A Kyiv Commercial Court ruling on July 6 banned official publication of the law, however. Two heavyweight politicians and high-ranking officials of the Tender Chamber -- Raisa Bohatyreva, leader of the Party of Regions Rada faction and honorary President of the Chamber, and Ksenia Lyapina, Our Ukraine MP and Vice President of the Chamber -- resigned from the Chamber in protest of Azarov's move.

¶3. (U) President Yushchenko responded on July 12 by issuing a decree aimed at managing procurement funds until the new Rada is in session. The President, through the National Security and Defense Council, requested law enforcement agencies to

audit state-owned enterprises to ensure adherence to the current law and proper use of government awards. The agencies must submit a report on the results of the investigation to Yushchenko by September 1. (Note: Post has heard anecdotal evidence that in fact some state-owned companies (in this case a subsidiary of the state-owned oil and gas company NaftoHaz) have not been following requirements for open tenders.)

Illegal Campaign Finance?

¶4. (SBU) Several press reports speculated that the GOU was pushing this new procurement law in order to enable state funding to be diverted to political campaigns of parties loyal to the government in the upcoming election. Lyapina reminded Econoff in a meeting on July 18 that Ukraine had a precedent for such a scheme, as the Party of Regions had diverted funds from state-owned NaftoHaz to fund its 2004 electoral campaign. The man behind that scheme, noted Lyapina, was none other than Azarov, making Azarov's motives in pushing this recent law very suspicious.

¶5. (C) In a July 27 meeting, Bohatyreva told Ambassador that the government procurement process was nontransparent and corrupt. She had tried to put an end to some of the corrupt schemes, she maintained, which brought her into conflict with a number of ministers. First Labor Minister Papiyev promoted one tender involving disabled people, which Bohatyreva had squashed. Then she had problems with EnergoAtom Head Derkach, Energy Minister Boyko, and Health Minister Haidayiv, all of whom she placed in Azarov and Klyuyev's circle. She said Azarov pushed for control of the Tender Chamber, and she was threatened and subsequently told to resign for the good

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of the party. Moreover, she was in Vienna for medical consultations when statements attacking Azarov were leaked in her name. Bohatyreva argued that the nontransparent procedures would continue regardless of who ran the Tender Chamber, but with her out of the chamber compromising materials about ministers might now be made public.

How the System Operates

¶6. (U) The law "On Procurement of Goods, Works, and Services for Public Funds" of February 22, 2000 established a single government procurement system. According to the law, subjected to a succession of amendments, all government procurement of goods and services (if valued at more than \$10,000) and works (if more than \$80,000) must be contracted via tenders (either open, or open with pre-qualification). According to Paul Birmingham, World Bank Director for Ukraine, Belarus and Moldova, Ukraine's procurement law largely complied with international standards until questionable amendments were made in 2006-2007. March 2006 amendments to the law "On Procurement" complicated the institutional framework, assigned overlapping tasks of monitoring public procurement to several bodies, and created rules that encourage conflict of interest. President Yushchenko initially vetoed this bill, but the Rada mustered enough votes to override.

¶7. (U) The Department of Coordination of State Procurement under the Ministry of Economy had been responsible for overseeing the procurement system until March 2006. The system was notoriously corrupt under the Ministry of Economy's oversight, and this authority was transferred to the Anti-Monopoly Committee. The Anti-Monopoly Committee is a strange choice for regulating government procurement, however, as it does not have particular competence in this area. The Netherlands is the only other country with such a practice.

¶ 8. (SBU) The 2006 amendments also established the Tender Chamber, an NGO, as a major player in the procurement process. The Tender Chamber became responsible for maintaining a catalogue of bidders, monitoring transparency, and assuring fairness. Transferring governmental functions to the private sector generated more negligence in the administration of public money. For example, the Tender Chamber maintains a UAH 7000 (\$1400) obligatory fee that bidders are forced to pay in order to be registered in the catalogue, in conflict with the international practice of free listing for all interested bidders. Lyapina told Econoff that, even as the Tender Chamber's Vice President, she was unable to determine how the decision to introduce this fee was taken.

¶ 9. (C) The Tender Chamber's membership includes not only governmental and parliamentary representatives, but also private sector associates. Press reports have often claimed that this situation creates conflict of interests since some of the Chamber members exploit their positions financially and informatively. Lyapina told Econoff that intermediaries had begun to control access by potential bidders to the Chamber. Of course, these intermediaries were charging fees for their "services," thus expanding the scope of corruption.

(Comment: If practice in other areas is any guide, we suspect intermediaries in turn may have been kicking back part of their fees to members of the Tender Chamber.)

Murky Supervision and Special Requirements

¶ 10. (U) The March 2006 amendments scattered policy and oversight functions across several bodies, including the Anti-Monopoly Committee, the Accounting Chamber (a supreme audit body, reporting to the Rada), the State Control and Audit Unit (a body for internal audit, under the Ministry of Finance), and the Tender Chamber. Experts argue that such fragmentation prevents the bodies from implementing effective and sound policy and contributes to a lack of transparency in the decision making process.

¶ 11. (U) The March 2006 provisions also introduced special
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security requirements for websites in order to be eligible for tender announcements. In May 2006, the Security Service of Ukraine (SBU) issued its conclusion that none of the proposed internet sites complied with the safety measures. Subsequently, however, the SBU allowed the European Consulting Agency, a Ukrainian private enterprise with links to the Tender Chamber, to operate a temporary website announcing the tenders. The European Consulting Agency continues to this day to operate a monopoly over tender announcements.

Sectoral Carve-Outs

¶ 12. (U) The March 2007 amendments created a legion of special public sectors, such as defense, postal and telecommunications services, and railways, for which procurement rules do not apply. While international norms do allow strategically important areas like national defense to be excluded from the general procurement rules, Ukraine's practice of "sectoral preference" is likely problematic in terms of compliance with international standards.

Foreigners Left Out

¶ 13. (U) The law "On Procurement" does not restrict foreign enterprises from participating in government procurement. In practice, however, foreign companies are rarely able to compete on an equal footing. Unclear rules and requirements,

secret wheeling and dealing, and corruption result in a low

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level of participation by foreign companies. According to the Anti-Monopoly Committee, foreign companies won tenders for only 0.01 percent of government procurement during the first six months of 2006.

Moving Toward the WTO

¶14. (SBU) Ukraine is not currently a signatory to the WTO Agreement on Government Procurement (AGP), but will become an observer to the AGP at the time of WTO accession (expected within 6-12 months), and has promised to begin negotiations to accede to the AGP after then. On December 11, 2006 the WTO Government Procurement Committee, which oversees the GPA, presented a roadmap for Ukraine's accession to the agreement.

President Yushchenko has tasked Valery Pyatnytskiy, Deputy Minister of Economy and Ukraine's lead WTO negotiator, to prepare a WTO-consistent draft law on procurement by September 15, 2007. A USAID-funded project is working with the Ministry of Economy on this draft law.

Comment: A Web of Corruption

¶15. (C) Public procurement cuts to the heart of governmental corruption, and Ukraine's track record in this area is not encouraging. Since independence, Ukrainian officials have used procurement rackets and kickbacks from state-owned companies as a handy way to line their pockets. Observers often cite NaftoHaz as a prime example of this kind of widespread procurement corruption. That the procurement process has gotten worse in recent years is of particular concern. The recent political infighting over amendments to the procurement law served to expose just how many layers of corrupt activity exist. Azarov's move to exempt state-owned enterprises from procurement rules, ironically, would actually bring Ukrainian practice more in line with WTO rules. However, the vehemence with which he attempted to ram through this change made us suspicious that truly substantial amounts of money were at stake; we strongly suspect Azarov's motive was likely to make it easier to pilfer from the companies' budgets. Azarov faced resistance from a leader within his own party (Bohatyрева) and the opposition (Ляпіна), yet it is hard to believe their motives were any more principled. As members of the Tender Chamber, it is logical they would have shared in the apparent flow of kickbacks, although we have no hard evidence to this effect. It seems that in Ukraine, corruption is one trait that crosses party lines.

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